Rathbones
Look forward

Review of the week

4 April 2022

A pinch and a punch

Cost of living fears seem to be peaking in the UK as a raft of important protections end. How will the economy hold up as households and companies tighten their belts?

The start of this month feels like something of a watershed moment for the UK. Some are calling it "awful April" as consumers and businesses alike come under growing pressure from an escalating cost of living squeeze. After months of big rises in the prices of food, fuel and other staples, most of us rushed to submit our gas and electricity meter readings ahead of the whopping 54% increase in the energy price cap that took effect on Friday.

The energy price spike coincides with a 2.5% combined increase in national insurance contributions paid by both employees and employers this month. On the back of higher food and other prices (as well as higher interest rates), these changes look set to exert significant pressure on people's disposable incomes and discretionary spending. Together, it's estimated that price rises and tax hikes will cost the average family more than £130 each month. UK inflation overall is running at more than 6% and is expected to rise above 8% this month following the increase in the energy price cap. This is way ahead of the rate at which people's wages and social security benefits are increasing. Bank of England (BoE) governor Andrew Bailey recently warned that people should be braced for a "historic shock" to their incomes.

Of course, the UK is hardly unique in terms of the challenges being exerted by much steeper inflation than we've seen in decades. **As we explained last week**, the current inflation burst is a global phenomenon, driven by the combination of post-pandemic reopening and the oil price shock triggered by Russia's invasion of Ukraine.

But it does look like the UK is in a particularly tight spot. In part, that's because it's withdrawing pandemic props more quickly than other countries. Government spending and taxation are getting less supportive. Alongside the increase in national insurance contributions, other taxes (like corporation tax) are going up too. Lots of UK businesses face a painful April 'cliff edge' as government pandemic support for all but the smallest comes to an end. The cut in the VAT rate for most goods and services in the hospitality industry is now reversed, meaning the cost of buying a pub meal or a hotel stay could get more expensive. Business rates relief is also being tapered, while protection from insolvency measures ended on 31 March and businesses that have fallen behind on their rent once again face the prospect of eviction as the government moratorium on rent debt is lifted.

At the same time, the BoE was the first big central bank to start implementing interest rate rises in a bid to tame inflation. The BoE sounded a bit more cautious at its most recent policy-setting meeting, explaining that it was worried about the growth outlook following the invasion of Ukraine. But BoE policymakers still believe that further rate hikes are warranted so UK rates are likely to rise further in the near term, especially if inflation continues to increase.

As UK consumers feel the pinch and start to rein in spending just as businesses contend with higher costs and the removal of important protections, it looks like the UK economy could be in for a particularly challenging period ahead.

What's the US yield curve telling us?

The UK economy may have been in the eye of the storm last week. But a closely watched recession indicator - the US Treasury yield curve - was flashing red on the other side of the pond. Typically, the yield on bonds increases with the time to maturity. That's because there's more time for things to go wrong before you get your money back, so you want a higher return for longer-dated bonds to compensate. A two-year bond should yield less than a 10-year bond, however, early in the week the two-year US Treasury yield rose above that of 10-year Treasuries - or 'the curve inverted' - for the first time since 2019. The gap widened as the week progressed, before Friday's US jobs data showed that jobs growth boomed in March, sending 10-year bond yields jumping back above two-year yields. The normalisation of the yield curve was due to the increasing likelihood that the US Federal Reserve (Fed) will stick with its aggressive programme of interest rate rises because of strong economic growth.

When yield curves invert, they typically spell trouble ahead for longer-term economic prospects: That's because shorter-term two-year yields move with interest rate expectations, while the 10-year yield moves in line with inflation and growth expectations. Yield curve inversion seems to be telling us that bond investors think Fed efforts to tame inflation with rate rises will stall economic growth. Inversions have preceded every US recession for the last 50 years.

As we have explained recently, we still don't think recession is the most likely scenario at a global level. But just two months ago, the risk of a recession being around the corner was as good as zero. So we're seeing a profound shift in investor expectations. While we think the prices of the assets most exposed already reflect a lot of the economic risks out there, we believe it makes sense to have exposure to more-defensive assets at this point.

If you have any questions or comments, or if there's anything you would like to see covered, please get in touch by emailing review@rathbones.com. We'd love to hear from you.

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